No. 11,976

IN THE

United States Court of Appeals

For the Ninth Circuit

GRACE BROS., INC.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONER'S OPENING BRIEF.

GEORGE H. KOSTER,
BAYLEY KOHLMEIER,
300 Montgomery Street, San Francisco 4, California,
Attorneys for Petitioner.

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IN THE

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Grace Bros., Inc., *Petitioner,* vs. Commissioner of Internal Revenue, *Respondent.*	

PETITIONER'S OPENING BRIEF.

JURISDICTIONAL STATEMENT.

This is an appeal from a decision of The Tax Court of the United States in which a deficiency in excess profits taxes was determined against petitioner for the year 1943. The findings of fact and opinion below are reported in 10 T. C. 158 and are set forth in full in the record herein. (R. 18.)

Petitioner is a California corporation which maintains its principal place of business in Santa Rosa, California. (R. 104.) Petitioner's income and excess profits tax returns for the year 1943 were duly filed with the Collector of Internal Revenue for the First District of California at San Francisco, California. (R. 4, 17.) Respondent determined a deficiency in petitioner's excess profits tax for the year 1943 in the

amount of $114,190.49 and on September 20, 1945, pursuant to Section 272 of the Internal Revenue Code, respondent sent to petitioner a notice of said deficiency. (R. 10.) On December 10, 1945, pursuant to Section 272 of the Internal Revenue Code, petitioner filed its appeal to The Tax Court of The United States from said deficiency determination and thereafter on February 24, 1947 filed an amended petition to The Tax Court of the United States and alleged therein that it had overpaid its excess profits taxes for the year 1943 by the amount of $23,913.11. (R. 4.) On March 19, 1947 respondent filed his answer to said amended petition, denying the claims and allegations of petitioner. (R. 16.) The appeal was called for hearing on May 26, 1947 and documentary and oral evidence was introduced by both parties. On January 27, 1948 The Tax Court of the United States promulgated its findings of fact and opinion (R. 18) and on April 5, 1948 the decision of the Tax Court was entered, determining a deficiency in petitioner's excess profits taxes for the year 1943 in the amount of $124,-073.01. (R. 31.)

On June 14, 1948, under authority of Section 1141 of the Internal Revenue Code (Title 26, U. S. Code, Section 1141, as amended by Section 504 of the Revenue Act of 1942), petitioner filed its petition for review by this Court of said decision of The Tax Court of the United States. (R. 32.) This appeal and the transcript of record herein were duly filed and docketed in this Court on July 16, 1948. (R. 141.)

STATEMENT OF THE CASE.

The controversy herein involves petitioner's correct excess profits tax liability for the year 1943, which in turn depends upon the determination of the following general issue: Whether the gain or any part thereof realized by petitioner in 1943 from the sale of its inventory of wine and its winery business is long term capital gain or ordinary income subject to excess profits tax.

Petitioner is a California corporation which was organized in 1910 and which maintains its principal place of business in Santa Rosa, California, (R. 104.) In 1943 and for many years prior thereto petitioner was engaged in various business enterprises including farming, cattle raising, manufacturing and selling ice, cold storage, and manufacturing and selling beer. (R. 104.) In 1921 petitioner acquired the DeTurk Winery in Santa Rosa, California and from 1921 until 1942 was engaged, in addition to its other activities, in the business of manufacturing and selling wine under the trade name of the DeTurk Winery. (R. 104.) The DeTurk Winery had been built in 1876 and had been continuously operated at the same location by petitioner and the prior owner from 1876 until the end of 1942. (R. 50.) The wine produced and sold under the name of the DeTurk Winery was of better than average quality and enjoyed a good reputation. (R. 20, 43.) The operating staff of the winery also included valuable and well trained men. (R. 24, 57.) During the period from 1936 to 1942, inclusive, petitioner realized net profits from its winery business

ranging from $7,995.20 to $33,184.93. Petitioner's net profit from said winery business during the year 1942 was $18,959.53. (R. 21.) During the year 1941 petitioner sold 157,518 gallons of dry wine in bulk and 8,888 gallons in bottles at an average price of 22.6¢ per gallon, and sold 46,943 gallons of sweet wine in bulk and 12,443 gallons in bottles at an average price of 37.2¢ per gallon. In 1942 petitioner sold 114,046 gallons of dry wine in bulk and 7,028 gallons in bottles at an average price of 22.2¢ per gallon, and 46,009 gallons of sweet wine in bulk and 10,268 gallons in bottles at an average price of 36.8¢ per gallon. As dry wine should be held for two years or more and red wine for one year for aging, petitioner kept a substantial inventory in stock. (R. 21.)

Some time prior to October, 1942 petitioner decided to go out of the winery business and to dispose of the DeTurk Winery. (R. 52.) As the result of this decision petitioner limited its production of wine in the 1942 vintage season to 4,959 gallons which it extracted from grapes grown by it, whereas normally petitioner's annual production was approximately 200,000 gallons. (R. 21.)

Mr. Joseph T. Grace, the president and sole stockholder of petitioner, was actively in charge of petitioner's business affairs. In November, 1942, Mr. Grace advised Mr. L. A. Weller, vice president of Garrett and Company, Inc. of New York, that petitioner intended to discontinue the wine business and carried on negotiatitons and correspondence with Garrett and Company through Mr. Weller with regard to

the sale of the wine and winery business of petitioner to Garrett & Co. (R. 21, 53.) Mr. Grace advised Mr. Weller that petitioner would not sell its wine inventory unless it sold everything connected with its wine business, including the winery and the good will. (R. 53.) At that time petitioner had an inventory of 522,-761 gallons of wine and Mr. Grace advised Mr. Weller that the winery was worth $125,000 and the inventory and good will were worth $250,000. (R. 104, 54.) Mr. Grace based his valuation of $250,000 for the wine and the good will by estimating that petitioner could realize $150,000 from the wine by continuing to sell it in the regular course of business and by estimating the value of the good will at five times the average annual net earnings of the wine business, making a good will value of $100,000. (R. 54-55.)

After numerous conversations and telegrams between Mr. Grace and Mr. Weller and other officers of Garrett and Co., on December 31, 1942 Garrett and Company offered to lease petitioner's winery and equipment for five years at an annual rental of $10,-000 and to purchase all of petitioner's wine at 50¢ per gallon (R. 55-56, 70-75). Since the amount to be paid by Garrett & Co. on this basis gave to petitioner the full amount it was asking for its wine and its winery business, petitioner accepted the offer and shipped 104,000 gallons of wine that day. Petitioner received $52,000 for the first shipment of wine and reported the income in its 1942 income tax return (R. 22.) Petitioner and Garrett & Co. entered into a written agreement, dated January 20, 1943, with regard to the trans-

fer of the wine and the lease of the property (R. 105, 111-116). In 1943 petitioner transferred the balance of its wine, consisting of 248,635 gallons of dry wine and 170,126 gallons of sweet wine, its bottles and cooperage, its DeTurk labels, its customer list, and its winery personnel to Garrett & Co. (R. 23, 106.) Petitioner also delivered possession of its winery to Garrett & Co. and surrendered its permit to manufacture and sell wine so that Garrett & Co. could procure a permit to operate a winery on the premises (R. 24, 57-58). After the transfer of the above assets, neither petitioner nor Mr. Grace engaged in the making or selling of wines (R. 24). During the year 1943 Garrett & Co. paid to petitioner $124,317.50, computed at 50¢ a gallon, for 248,635 gallons of dry wine, $94,862.41 computed at 50¢ a gallon for 96,498 gallons of sweet wine, and a somewhat higher price per gallon for 73,628 gallons of sweet wine which contained a higher sugar content than was required by California standards (R. 23, 106). As the total price agreed upon was slightly greater than the price originally asked, Mr. Grace considered that petitioner had sold the entire business, including good will, to Garrett & Co. and that petitioner had received $100,000 for the good will of the winery business (R. 54, 56).

In its income tax return and its excess profits tax return for 1943 petitioner treated the sale as a sale of capital assets held for more than six months and reported a long term capital gain in the amount of $140,133.58, which gains are not subject to excess profits tax (R. 127). Respondent treated the gain

from the sale as ordinary business income and thereby substantially increased petitioner's net income subject to excess profits tax and substantially increased petitioner's excess profits tax liability for 1943 (R. 13).

In its appeal to the Tax Court petitioner presented the following contentions:

1. At least $100,000 was received by petitioner for its good will which was unquestionably a capital asset and therefore at least $100,000 of the gain was long term capital gain realized from the sale of the good will.

2. The transaction with Garrett & Co. involved the disposition of a unitary business as distinguished from particular assets, and therefore the entire profit from the transaction should be treated as long term capital gain and taxed accordingly.

3. When petitioner decided to discontinue making wine and to dispose of the winery business, the wine on hand ceased to be held for sale to customers in the ordinary course of petitioner's business, and became a capital asset, and having been held for more than six months (except the 4,959 gallons manufactured in 1942) the gain constituted long term capital gain.

The Tax Court disregarded the testimony of the witnesses and determined that the transaction between petitioner and Garrett & Co. was not a disposition of the business as a unit and further determined that since the winery was leased and not sold to Garrett & Co. and since the price was determined on the basis of 50 cents per gallon for the wine, the sale did not

cover anything but wine, that the wine was not converted into a capital asset and that no part of the consideration received by petitioner was received for good will or other intangible assets. The Tax Court affirmed the determination of respondent. (R. 25-30.)

SPECIFICATIONS OF ERROR.

In making and rendering its decision, as aforesaid, The Tax Court of the United States erred to the prejudice of petitioner in the following respects:

1. In determining a deficiency in petitioner's excess profits tax for the calendar year 1943 in the amount of $124,073.01.

2. In failing to determine that there was no deficiency in excess profits tax due from petitioner for the year 1943 and that petitioner overpaid its excess profits tax for said year by the amount of at least $23,913.11.

3. In determining that the stock of wine sold by petitioner during the year 1943 was not a capital asset and that the gain derived therefrom was ordinary income and not capital gain.

4. In determining that the transaction with Garrett & Co. did not involve the disposition of a unitary business, as distinguished from particular assets, the profit from which should be treated as long term capital gain.

5. In determining that no part of the consideration received by petitioner for its wine and other assets connected with its winery business

was received for the good will of said winery business.

6. In failing and refusing to determine that at least $100,000 of the consideration received by petitioner for its wine and other assets connected with the winery was received by petitioner for the good will of petitioner's winery business.

7. In failing and refusing to accept the uncontradicted testimony of the president of petitioner that the petitioner sold its good will and that the consideration received by petitioner upon the sale of its wine and other assets of its winery business exceeded the fair market value of the tangible assets sold by at least $100,000 and that said $100,000 represented consideration received by petitioner for the good will of its winery business.

SUMMARY OF ARGUMENT.

I. The evidence clearly establishes that in the transaction with Garrett & Co. it was petitioner's intention to sell its entire winery business including the good will of that business which petitioner valued at $100,000, that petitioner advised Garrett & Co. that it would not sell any of the assets of its winery business unless it sold the entire business including the good will, that the selling price fixed by petitioner included $100,000 for the good will, that Garrett & Co. offered and petitioner accepted a price, computed on the basis of fifty cents per gallon for the wine, which was slightly larger than the price asked by petitioner for the assets transferred, including the good will. As

petitioner received the full price it asked it considered that it received full consideration for its good will.

While the written communications between the parties were in the form of a sale of wine and a lease of the winery the evidence establishes that the transaction was intended to be and was in substance and effect, if not in form, a sale of the entire winery business including the good will.

The courts have recognized that a sale of a going business necessarily involves a sale of the good will of the business and have held that a portion of the price must be allocated to the good will.

The Tax Court erred in ignoring the uncontradicted testimony of a qualified witness and in refusing to consider the substance and effect of the entire transaction and its determination that the transaction did not involve a sale of good will was clearly erroneous and should be reversed.

II. As the transaction between petitioner and Garrett & Co. was a sale of the entire winery business as a going concern the gain realized therefrom was long term capital gain and the Tax Court erred as a matter of law in determining that the gain was ordinary income.

III. When petitioner determined to discontinue its winery business and to sell all the assets thereof the wine inventory ceased to be held primarily for sale to customers in the ordinary course of business and became a capital asset. The gain realized from the

sale of the wine, except the 4,959 gallons produced in 1942, constituted long term capital gain. The Tax Court erred as a matter of law in determining that the wine did not become a capital asset and that the gain from the sale thereof was ordinary income.

ARGUMENT.

I. INTRODUCTORY STATEMENT.

The issues presented to the Tax Court in the proceeding below and the issues presented to this Court in this appeal arise out of the sale by petitioner of the assets owned and used by it in the operation of its winery business prior to the sale. There is no controversy with regard to the cost or other basis of the assets sold, the total consideration received by petitioner upon the sale, or the total gain realized from the sale. The basic issue involved is whether all or any part of the gain realized by petitioner was capital gain or ordinary income. The determination of this basic issue depends upon the determination of the subordinate issues of (1) whether part of the consideration was received by petitioner for the good will of its business, (2) whether the transaction was a disposition of a unitary business as distinguished from particular assets, and (3) whether the wine involved was converted into a capital asset before the sale. The determination of *any* of the above issues in favor of petitioner will require the reversal of the decision of the Tax Court.

The determination of the above issues has an important effect for tax purposes for the reason that long term capital gains were not subject to the excess profits tax which was in effect for the year 1943, whereas ordinary income was subject to the excess profits tax.

Petitioner's interpretation of the transaction is that it was a sale of its entire winery business, including the good will, and not a mere sale of its stock of wines as determined by respondent and the Tax Court. Petitioner contends that at least $100,000 of the consideration received by it for the business and assets was received for good will and constituted capital gain. Petitioner further contends that its decision to discontinue the operation of the winery business and to sell all of the assets thereof effected a conversion of the wine held in inventory to a capital asset and that the gain realized upon the subsequent sale of the business and assets was capital gain.

Under petitioner's interpretation of the transaction the entire profit realized was capital gain and petitioner reported the gain accordingly in its income tax return. Respondent determined that the transaction involved only a sale of wine and that the entire gain was ordinary income. The Tax Court sustained respondent's determination.

The above issues are mixed questions of law and fact which involve the legal effect and the proper legal interpretation of the facts established by the evidence in the case. Petitioner does not challenge any

of the facts specifically found by the Tax Court in its Findings of Fact. However, in its opinion the Tax Court states that it is unable to find certain facts which petitioner contends are clearly established by the evidence. The statements in the opinion of the Tax Court were not made as findings of fact, but merely as comments on the evidence and should not be accepted as findings by the Court. *Kelleher v. Commissioner* (CCA-9, 1938) 94 F (2d) 294; *Aronson v. Commissioner* (CCA-9, 1938) 98 F (2d) 23; *Belridge Oil Company v. Helvering* (CCA-9, 1934) 69 F (2d) 432. But even if the statements, which will be specifically discussed in the following portions of this brief, can be considered as findings of fact, it is petitioner's contention that the inferences and conclusions of the Tax Court are not supported by any substantial evidence, are contrary to the uncontradicted testimony of the witnesses and other competent evidence in the record and are clearly erroneous.

This Court has full power and jurisdiction to review the findings and conclusions and decision of the Tax Court and is no longer restricted by the doctrine of *Dobson v. Commissioner* 320 U. S. 489, 64 S. Ct. 239, 88 L. Ed. 248. Section 1141(a) of the Internal Revenue Code, as amended by Section 36 of Public Law 773, 80th Congress, Second Session, which became effective on September 1, 1948 provides:

> "The Circuit Courts of Appeals and the United States Court of Appeals for the District of Columbia shall have exclusive jurisdiction to review the decisions of the Tax Court, except as

provided in Section 1254 of Title 28 of the United States Code, *in the same manner and to the same extent as decisions of the district courts in civil actions tried without a jury;* * * *" (Italics supplied.)

Appellate courts have full power to review conclusions of law of the trial Court and also have power to review findings of fact subject to the limitation contained in Rule 52(a) of the Rules of Civil Procedure for the District Courts of the United States which provides "* * * Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial Court to judge of the credibility of the witnesses". While, under the above rule, the appellate courts have refused to set aside pure findings of fact of the trial Court, supported by substantial evidence, the courts have generally held that appellate courts have full power to review and set aside findings which are based upon a misapplication of misinterpretation of the law to the evidentiary findings and are not bound by the trial Courts' inferences and conclusions drawn from undisputed evidentiary facts.

Kuhn v. Princess Lida of Thurn & Taxis, 3 Cir., 1941, 119 F (2d) 704; *Compana Corp. v. Harrison,* 7 Cir., 1940, 114 F (2d) 400; *United States v. Armature Rewinding Co.,* 8 Cir., 1942, 124 F (2d) 589.

In the recent decision of *United States v. United States Gypsum Co.,* 1948, 333 U. S. 364, 92 L Ed (Ad. Op.) 552, 68 S. Ct. 525, the United States Supreme Court set aside numerous findings of fact of the dis-

trict Court after a careful and extensive review of the evidence on the ground that the findings were clearly erroneous. The Supreme Court defined the meaning of "clearly erroneous" as used in Rule 52(a) (supra) as follows:

> *"A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed."* (Italics supplied.)

As stated above petitioner is not challenging the facts set forth in the Tax Court's findings of fact but does contend that the ultimate conclusions of the Tax Court are clearly erroneous, are based upon inferences and interpretations of the evidence which are not supported or justified by the facts and upon misinterpretations of applicable principles of law. This Court has full power to review conclusions of law of the Tax Court and under the law as amended and the above cited decisions has power to review findings of fact and may set aside findings of fact as clearly erroneous if upon the entire evidence the Court is of the definite and firm conviction that the Tax Court committed a mistake.

II. AT LEAST $100,000 OF THE CONSIDERATION RECEIVED BY PETITIONER FOR THE ASSETS OF ITS WINERY BUSINESS WAS RECEIVED BY PETITIONER FOR THE GOOD WILL OF ITS SAID BUSINESS AND CONSTITUTED CAPITAL GAIN.

(a) Summary of pertinent facts.

One of the questions presented to and decided by the Tax Court was whether any part of the consideration received by petitioner upon the sale of the assets of its winery business was received for the good will of said business. In its opinion (R. 27), the Tax Court stated that it was unable to find that petitioner sold anything not covered by the sale contract (Stip. of Facts, Ex. 2-B) (R. 111). In order that petitioner's contentions with regard to this issue may be clearly understood it is necessary to summarize the facts.

In 1942 and prior thereto petitioner was engaged in various business enterprises including farming, cattle raising, manufacture and sale of ice, cold storage, manufacture and sale of beer and the manufacture and sale of wine. (R. 20, 104.) Petitioner entered the wine business in 1921 when it acquired the DeTurk Winery which had been constructed in 1876 and had been continuously operated under that name at the same location. Petitioner continued in the wine business under the name of DeTurk Winery until the end of 1942 and operated said business as a separate enterprise from its other operations. (R. 104.) The wine produced and sold by petitioner under the name of the DeTurk Winery was of better than average quality and enjoyed a good reputation. (R. 20, 43.)

Likewise the operation of the winery was successful and produced a good income. (R. 21, 121.)

Sometime prior to October, 1942, petitioner decided to go out of the wine business and reduced its wine production in 1942 from a normal 200,000 gallons to 4959 gallons which it extracted entirely from grapes grown by it. (R. 21, 105.) Mr. Joseph T. Grace, who was the sole stockholder, president and active manager of petitioner's business affairs talked to different people about the sale of the wine business and in November, 1942, he advised Mr. L. A. Weller, vice-president of Garrett & Co., Inc., of New York, that petitioner intended to dispose of its wine business. Mr. Grace advised Mr. Weller that the winery was worth $125,000 and that the inventory and good will were worth $250,000, making a total of $375,000 for everything. In determining that the wine inventory and good will were worth $250,000 Mr. Grace estimated that the wine could be sold at current prices for approximately $150,000 and he valued the good will at $100,000. (R. 54.)

At another meeting shortly thereafter Mr. Weller inquired as to whether petitioner would lease its winery and stated, "*I can give you what you ask for your wine inventory and everything that goes with it, the good will, which would be equivalent to $250,000. * * * If I give you fifty cents a gallon, that will give you what you are asking.*" (R. 56.)

Thereafter there were a series of telegrams and conversations between the parties which referred pri-

marily to wine and which finally resulted in an agreement which provided for the sale of petitioner's wine (approximately 520,000 gallons at fifty cents per gallon plus a small additional amount for wine which had a higher sugar content than that required by California standards), and the lease of the winery and equipment for a term of five years with the right of renewal at an annual rental of $10,000 per year. On December 31, 1942, petitioner delivered 104,000 gallons of wine and received $54,000 therefor. In 1943 petitioner delivered the remaining 418,761 gallons of wine and received $219,179.91. Petitioner also transferred to Garrett & Co. its wine stocks, its cooperage, its labels, its list of customers and its staff of eight or ten experienced employees and surrendered its permit to manufacture and sell wine so that Garrett & Co. could procure a permit to operate on the premises. Thereafter neither petitioner nor Mr. Grace engaged in making or selling wine. (R. 22-24.)

The record in this case leaves no room for doubt that the winery business of petitioner, which was separately operated under the name of DeTurk Winery, possessed good will which had a substantial value. The good reputation of the product, the earnings of the business and the testimony of qualified witnesses all establish that fact. Mr. Morrow, who had been engaged in the wine business for fifty-five years and who was thoroughly familiar with petitioner's wine and business, testified that petitioner's wine business had a substatntial going concern or good will value. (R. 44, 45.) Mr. Grace, the president and active man-

ager of petitioner, valued the good will of petitioner's wine business at $100,000 (R. 55, 60) and Mr. Tapp, an experienced banker, with extensive experience in and knowledge of the wine business, testified that a business such as that of the DeTurk Winery would have a good will value of approximately $160,000. (R. 99.) There is also a legal presumption that a profitable business has a good will or going concern value over and above the value of the tangible assets. *Pfleghar Hardware Specialty Co. v. Blair*, 2 Cir., 1929, 30 F (2d) 614; *Helvering v. Security Savings and Commercial Bank*, 4 Cir., 1934, 72 F (2d) 874; *White and Wells Co. v. Commissioner*, 19 BTA 416; *Wyman and Co. v. Commissioner*, 8 BTA 408. See also *Randolph Paul, Federal Estate and Gift Taxation*, Vol. 2, p. 1242.

The Tax Court did not question the fact that there was a substantial good will value in petitioner's winery business, but based its decision upon the determination that the transaction between petitioner and Garrett & Company did not involve the sale of petitioner's good will and that the entire consideration received by petitioner was paid to it for the wine inventory. The petitioner contends that the determination of the Tax Court that no part of the consideration received by petitioner was received by it for its good will or going concern value is not supported by the evidence in the record or the applicable principles of law.

(b) The evidence establishes that petitioner intended to and actually did sell its good will.

The uncontradicted testimony of Mr. Grace, who represented petitioner in the negotiations, was that petitioner would not sell its wine inventory except as a part of the sale of all the assets of the winery business, including the good will which he valued at $100,000, and he so advised the purchaser. (R. 53, 54.) The purchaser offered to lease the winery instead of purchasing it and offered to purchase the wine at a price which would give petitioner an amount equal to the price at which the wine, the good will and the other assets had been included in petitioner's original offer. (R. 56.) Thereafter, the telegrams which passed between the parties and the final letter which evidenced the agreement referred only to the wine and established the total consideration on the basis of the wine transferred. The evidence clearly establishes, however, that despite the wording of the telegrams and the agreement letter, petitioner actually transferred and delivered to Garrett & Co. by sale and lease, not only wine, but also all the other assets of its wine business, including its labels and list of customers, transferred its staff of experienced employees to Garrett & Co. and surrendered its permit to manufacture and sell wine so that Garrett & Co. could procure a permit to operate on the premises.

Upon the completion of the transaction Garrett & Co. owned all of the assets, tangible and intangible, which petitioner had formerly owned and used in its wine business, except the winery and equipment, and

Garrett & Co. had a five year lease of the plant and equipment with the right of renewal. The above facts are not disputed and were found by the Tax Court. These undisputed facts clearly establish that despite the form of the transaction and the phraseology of the telegrams, the effect of the transaction was the transfer of the entire wine business and all of the assets thereof to Garrett & Co. The uncontradicted testimony of Mr. Grace also clearly establishes that it was the intention and understanding of petitioner that all of the assets, including the good will, were being sold and that the sale would not have been made on any other terms. (R. 53, 56.)

In its opinion the Tax Court specifically refers to the testimony of Mr. Grace with regard to the terms of the offer of sale which included $100,000 for petitioner's good will but concluded, "We cannot find such an offer upon the evidence adduced." (R. 25.) The refusal of the Tax Court to give any weight or consideration to the uncontradicted testimony of Mr. Grace constituted reversible error. *Foran v. Commissioner,* 5 Cir., 1948, 165 F (2d) 409; *Tatt v. Commissioner,* 5 Cir., 1948, 166 F (2d) 697.

Furthermore, the consideration received by petitioner, while technically computed on the basis of the wine transferred, was approximately the amount which petitioner requested for all of the assets which it sold, including its good will, and exceeded the price asked for the wine by more than $100,000. After the conclusion of the transaction petitioner had surrendered its permit to manufacture and sell wine and

had retained no part of the wine business or the assets thereof, except title to the winery and equipment which had been leased for five years, with right of renewal. By the transfers petitioner completely disposed of the good will of its winery business and the only logical and fair conclusion from all the evidence is that a portion of the consideration was received by petitioner for its good will.

(c) Applicable decisions establish a legal presumption that petitioner sold its good will when it sold its business.

The above conclusion is further supported by Court decisions which hold that the sale of a going business necessarily involves a sale of the good will of the business even though the good will is not specifically transferred or even mentioned in the contract between the parties. *White & Wells Co. v. Commissioner,* 19 BTA 416, 2 Cir., 1931, 50 F. (2d) 120; *Pfleghar Hardware Specialty Co. v. Blair,* 2 Cir., 1929, 30 F. (2d) 614; *Betts v. United States,* 62 Ct. Cls. 1.

In *Didlake v. Roden Grocery Co.,* 160 Ala. 484, 495, 49 So. 384, 387, the Court stated:

> "* * * But the authorities are clear to the effect that, if a business is sold out entirely and nothing is said about good will, it goes with the property. This necessarily results from the fact that the good will cannot exist except in connection with the business."

White & Wells Co. v. Commissioner (supra) and *Pfleghar Hardware Specialty Co. v. Blair* (supra) are almost identical in all material respects with the present case and in each of said cases it was held that

there was a sale of the good will of the business even though the contract of sale made no mention of good will and the transactions were in form mere sales of tangible assets.

White & Wells Co. v. Commissioner (supra) is exactly in point, and because this case seems undistinguishable and appears to be uncontrovertible authority to support a decision in favor of this petitioner, a review of that case follows:

White & Wells Co. operated two factories manufacturing paper boxes. The boxes manufactured in one of the factories were sold almost exclusively to two rubber companies. After a number of years, White & Wells Co. decided to sell this factory and finally did sell it to one of the rubber companies. It was not the intention of the rubber company to go into the paper box business or sell boxes to the public, but merely to manufacture them for use in its own business. The contract of sale entered into between White & Wells Co. and the rubber company specified only the sale of the land, buildings and equipment. The taxpayer contended that when it sold the factory, it sold a going business to which there was attached certain good will value and it should therefore be allowed to set up as part of the cost basis a March 1, 1913, value for the good will in determining the profit or loss from the sale. The Government contended that the good will was not sold and in the alternative objected to the taxpayer's computation of the good will value. The Board states the Commissioner's contentions as follows:

"In this proceeding, the respondent attempts to differentiate the *Pfleghar Hardware Specialty Co.* case from the instant case since in the former, the company sold its plant and went out of business, whereas, in the instant proceeding, the petitioner sold only one of its factories and continued in the general paper box business. It is further contended that the United States Rubber Co. did not buy the good will of the petitioner or of the Naugatuck Factory because the Naugatuck Factory was designed especially for manufacturing supplies for the rubber company; that it was not necessary for the rubber company to buy any good will of the plant."

The Board after concluding that *"It is to be assumed that the manufacturer doing a profitable business will not sell his plant at any date for the residual value of its tangibles"* (italics supplied) determined that there was a disposition of intangible value in the transaction and that in computing profit from the sale of the factory, the March 1, 1913, value of the intanagible assets should be considered as part of the basis. The final and concluding paragraph of the Board's decision is significant in that it recognizes without question that even though the formality of the sale involved only the sale of the tangible property, there was, nevertheless, to be recognized as inherent in the transaction, a disposition of the intangible or going business value of the tangible property, and that final paragraph reads as follows:

"From a consideration of the entire record, we reach the conclusion that the going concern value of the petitioner's Naugatuck Factory on March

> 1, 1913, was the amount of $31,441.60, which amount added to the residual value of the tangibles of $67,904.86, gives a basis for the determination of the profit upon the sale of the Naugatuck Factory of $99,346.46. Since such factory was sold in 1920 for $150,000 cash, the profit realized upon the sale was $50,653.54."

This case was appealed to the United States Circuit Court of Appeals for the Second Circuit, 50 Fed. (2d) 1209, and that Court agreed with the determination that the good will was sold but remanded the case back to the Board with instructions that in using earnings for an average period of years for the purpose of computing the value of the good will, the Board should include within the period certain years in which good earnings were realized in order that the period as a whole would reflect a fair average and measure for the valuing of the good will.

Just this recital of the *White & Wells Co.* case is sufficient to show its resemblance to present case. This case is even stronger in that there is ample evidence in the record that the petitioner intended to dispose of its intangible assets and included a price for those assets in the overall price which it quoted Garrett & Co. for the entire business and which it finally received in the transaction, and petitioner never reengaged in the winery business.

In *Pfleghar Hardware Specialty Co. v. Blair* (supra) the Pfleghar company was engaged in the business of manufacturing and selling articles of hardware. It had one principal customer which pur-

chased 90% of its output and which sold the articles purchased under its own name and not under the name of Pfleghar. In 1919 the customer purchased Pfleghar Company's plant and equipment, exclusive of inventory, as a whole as a going concern for $300,000. Pfleghar contended that it sold its good will and was entitled to include the March 1, 1913 value of the good will as a part of its cost in computing its profit on the sale. The Commissioner contended that there was no sale of good will in 1919 and that Pfleghar had no good will of value in 1913. The Board of Tax Appeals held for the Commissioner on the groud that while whatever intangible asset Pfleghar owned was transferred to the purchaser the evidence did not establish any value for good will in 1913. On appeal the Circuit Court for the Second Circuit reversed the decision of the Board of Tax Appeals on the grounds that the taxpayer had good will of value in 1913 and that since the subject of the sale was a manufacturing plant in production as a going concern the seller sold its good will.

In each of the cases discussed above the contracts of sale made no mention of good will, the good will of the seller was of no apparent value to the purchaser and the Commissioner contended, as in this case, that there was no sale of good will. The Courts held, however, that since the transactions involved the transfer of a going business the good will of the seller was included among the assets sold.

The principle of the above cases is directly applicable to the present case. As shown above petitioner

transferred its entire business as a going concern, including its staff of experienced employees, to Garrett & Co., retained no part of the business and thereafter completely ceased all operations in the wine business. Such a transfer of an entire business necessarily includes the transfer of the good will of the seller regardless of the terms of the contract of sale.

(d) The grounds and reasons relied upon by the Tax Court are not supported by the evidence and are contrary to the applicable principles of law.

The Tax Court based its decision herein primarily upon the fact that the telegrams between the parties did not suggest an intention to sell the winery, the fact that the winery was leased and not sold, the fact that the final price was computed on the basis of the wine transferred and the Court's belief that Garrett & Co. would not have paid $100,000 for good will which the Court considered that it abandoned a little over a year later by canceling the lease. (R. 25-28.) None of the points relied upon by the Tax Court are sufficient to justify a determination that petitioner did not sell its good will or to distinguish *White & Wells Co. v. Commissioner* (supra) or *Pfleghar Hardware Specialties Co. v. Blair* (supra.)

The decision of the Tax Court also appears to be based to a large extent upon the assumption that there can be no sale of a business as a going concern or of the good will of a business unless the transaction includes the sale of the physical plant. The Tax Court clearly confused the business with the plant for the Court states "We should be impressed by this

argument (that there was a sale of a going business and such sale necessarily included a transfer of the good will) if there had been a sale as in the cited cases [*White & Wells Co. v. Commissioner* (supra) and *Pfleghar Hardware Specialties Co. v. Blair* (supra)], but under the facts here shown the advantages of what ever good will was inherent in petitioner's business passed to Garrett & Co. by lease, not by sale, * * *". (R. 26.) The basic assumption of the quoted statement, that there cannot be a sale of a going business unless the physical plant is sold is obviously fallacious. Good will is seldom inherent in a plant and equipment except possibly where location is the principal element of the good will. Likewise the abandonment or sale of the plant and equipment without a transfer of the business itself does not effect an abandonment or transfer of the good will of the business. *Wm. Wailes v. Commissioner,* 25 BTA 278.

There are many businesses with valuable good will which do not own the plant and equipment used and it is by no means unusual for one concern to buy the business and good will of another concern without buying or even leasing the physical plant and equipment of the seller. It so happened that in *White & Wells Co. v. Commissioner* (supra) and in *Pfleghar Hardware Specialties Co. v. Blair* (supra) the plants and equipment were sold, but that fact does not appear to have any important bearing upon the decisions in those cases.

In the present case there was much more than a mere sale of merchandise and a lease of the plant and equipment as stated by the Tax Court. Petitioner transferred its entire inventory of wines, its labels, its customer list, its employees, and it surrendered its permit to engage in the wine business and gave the purchaser a five year lease with right of renewal of the plant and equipment. Petitioner retained no part of its wine business and did not again engage in that business. Petitioner's intention to completely dispose of its wine business is corroborated by the fact that a year later it sold the plant and equipment and thereby disposed of the last interest it held in assets formerly used in the business. The leasing of petitioner's plant and equipment in connection with the sale and transfer of all the other assets was as effective for all practical purposes as a sale would have been and the fact that the plant was not sold does not make the rule of the above cited cases inapplicable, nor justify the conclusion that petitioner did not sell its entire business, including its good will.

The fact that the telegrams between the parties and the contract letter referred only to wine and the final price was based upon the quantity of wine transferred is of little importance when considered with all the evidence. Mr. Grace testified that he advised Mr. Weller that petitioner would not sell its wine except as a part of a sale of the entire business and all of the assets thereof, including the good will and he quoted a price of $375,000 which consisted of $125,000 for the plant and equipment, $150,000

for the wine inventory, and $100,000 for the good will. (R. 53-54.) Mr. Weller offered to lease the plant and stated that Garrett & Co. could give petitioner its price for the remaining assets by paying 50¢ per gallon for the wine. (R. 56.) As petitioner was willing to lease its plant in connection with the sale of the other assets of the business and the purchaser was willing to pay the price petitioner asked, the method employed in determining the price was obviously of no great importance to petitioner. Mr. Grace testified that he felt that petitioner was getting the price it was asking for the good will, the organization and all that. (R. 56.)

The conclusion that the transaction between petitioner and Garrett & Co. was merely a sale of wine can be reached only by ignoring all the evidence except the written communications and refusing to interpret the written documents in the light of the intention and understanding of the seller, the actual performance and the effect of the entire transaction. While the trial Court has broad powers in determining the facts of a case and interpreting the evidence, it cannot ignore competent evidence and base its determination upon a small portion of the evidence. *United States v. United States Gypsum Co.,* 1948, 333 U. S. 364, 92 L. Ed. (Ad. Op.) 552, 68 Sup. Ct. 525; *Fleming v. Palmer,* 3 Cir., 1941, 123 F. (2d) 749; *Belridge Oil Co. v. Commissioner,* 9 Cir., 1936, 85 F. (2d) 762.

The Tax Court also based its determination to a large extent upon its belief that Garrett & Co "would not have paid $100,000 * * * to obtain good will which

it abandoned a little over a year later by canceling the lease* * *." There is nothing whatsoever in the record to justify such belief, and the Tax Court has no power to substitute its judgment as to the sagacity of a business transaction for that of the parties. See *Belridge Oil Co. v. Commissioner* (supra). Further more, the mere abandonment of a plant in connection with the transfer of the business to another location does not constitute an abandonment of good will. *Wm. Wailes v. Commissioner,* 25 BTA 278.

The Tax Court's belief in this regard was obviously influenced by its erroneous assumption that good will attaches to and is inseparable from the physical plant employed in the business.

While it may be that Garrett & Co. had no immediate need or desire for petitioner's good will, the same could be said of the purchasers in *White & Wells Co. v. Commissioner* (supra) and *Pfleghar Hardware Specialties Co. v. Blair* (supra), and it does not follow that the good will was not sold and transferred along with the other assets. The record does clearly establish that petitioner intended and understood that its good will was being sold and would not have entered into the transaction on any other basis and that the purchaser was so advised. The record also establishes that the price paid was approximately the amount asked by petitioner for all the assets sold including its good will. We are here concerned with petitioner's income and tax liability which must be determined on the basis of the assets which petitioner sold and transferred and not on the basis of

what the purchaser wanted or what it did with the assets after the purchase.

In the case of *Ida P. Huggins,* 1 T. C. 1214, P. H. T. C. Memo, Dec. Vol. 12, ¶ 43172, petitioner owned a piece of property improved with a building from which she was obtaining rentals. Sears Roebuck wanted the land for the erection of a retail store but had no use for the buliding. Sears Roebuck purchased the property for a lump sum payment and immediately demolished the building. The petitioner argued that since Sears Roebuck wanted only the land practically the entire sales price should be allocated as the selling price of the land, and only an amount equal to the junk value of the building should be allocated as the selling price of the building. Since the gain on the land was a capital gain and the loss on the building an ordinary loss the petitioner would have effected a tax saving if her contention had been sustained. The Tax Court in sustaining the Commissioner rejected her contention, and pointed out that in determining her tax liability the transaction must be analyzed from her point of view or from a reasonable construction of the transaction as it affected her regardless of the purposes or objectives intended by the other party to the transaction. The Tax Court pointed out that the building was an income producing assets and it was reasonable to assume that the petitioner would not have disposed of an income producing asset without receiving some consideration for it and the Court therefore allocated a fair portion of the selling price as the selling price

of the building regardless of the fact that Sears Roebuck from its point of view probably paid the entire price for the land alone.

In principle, the same situation exists in the instant case. It can be assumed for the moment that in the transaction here involved, Garrett & Co. was primarly interested in obtaining a stock of good wines and a going plant, as distinguished from a going manufacturing business. The sale of the wine alone would have meant the end of the DeTurk Winery business and the taxpayer indicated quite clearly that it wanted to sell its wine business and that it would not dispose of the wine without disposing of the entire winery business including the plant and the good will. The petitioner is contending here exactly what the Government contended in the *Ida P. Huggins* case, supra, namely, that insofar as the petitioner was concerned, it was disposing of one of its income producing assets, its good will or going concern value, and part of the selling price should be allocated to that asset. If the principle of the *Ida P. Huggins* case is sound it must be concluded that this petitioner would not have entered into a transaction involving the disposition of its wine business without receiving consideration for the good will thereof which was one of the income producing assets of substantial value *to the petitioner,* and therefore some part of the price received from Garrett & Co. should be allocated as being received for that asset, and it must be concluded further that this allocation

should be made regardless of how Garrett & Co. handled the transaction.

Petitioner submits that the principle of *Ida P. Huggins* (supra) is directly applicable to this case and that the issues presented must be determined by interpreting the transaction as it applied to petitioner without regard to what the purchaser may have wanted out of the transaction. Whether or not Garrett & Co. would have paid $100,000 or anything at all for petitioner's good will as such is immaterial. The important fact is that petitioner would not have sold its business or assets piecemeal, insisted that its good will be purchased along with the other assets of the business and actually received the total price it asked for all of its assets, including its good will. When all the facts and circumstances are considered the only reasonable conclusion is that petitioner sold its entire wine business including its good will.

The opinion of the Tax Court clearly discloses that in reaching the conclusion that the transaction between petitioner and Garrett & Co. was merely a sale of wine and a lease of the plant and equipment the Court completely ignored the uncontradicted testimony of Mr. Grace as to the intention and understanding of petitioner, completely ignored the substance and effect of the transaction as a whole, completely disregarded the principle of *White & Wells Co. v. Commissioner* (supra) and *Pfleghar Hardware Specialties Co. v. Blair* (supra) and based

its conclusion entirely upon the form of the written documents and the erroneous assumption that there cannot be a sale of good will of a business without a sale and transfer of the physical plant and equipment. It is respectfully submitted that the Tax Court erred as a matter of law in disregarding the uncontradicted testimony of a competent and well qualified witness, in refusing to give any consideration and weight to the substance and effect of the entire transaction and in basing its conclusion entirely upon the form and wording of the written communications and the formal contract and upon inferences and assumptions not supported by the evidence or by established principles of law.

(e) The facts and evidence establish that at least $100,000 of the consideration received should be allocated to the good will.

As the Tax Court concluded that the transaction between petitioner and Garrett & Co. did not include a sale of the good will it did not consider the allocation of the consideration received by petitioner between the good will and the assets sold. The record does contain facts and evidence from which a fair allocation of the consideration can be made.

Mr. Grace testified that at the inception of the negotiations he quoted to Mr. Weller a total price of $375,000 which was composed of $125,000 for the plant and equipment, $150,000 for the wine inventory and $100,000 for the good will (R. 54.) He further testified that he determined the value of the wine inventory at the price for which it could have been

sold in the regular course of business and determined the value of the good will at five times normal earnings (R. 60.) The elimination of the plant and equipment from the assets being sold reduced the total consideration asked to the $250,000 asked for the wine and good will. The price finally agreed upon and received was $271,179.91.

The Stipulation of Facts (par. 6, R. 104) shows that the average price at which the DeTurk Winery had been selling its wine in the year 1942 was 22.2¢ per gallon for dry wine and 36.8¢ per gallon for sweet wine. The wine involved in the sale to Garrett & Co. was 352,635 gallons of dry wine and 170,126 gallons of sweet wine. (R. 105.) By applying the average prices to the gallonage the amount which DeTurk Winery would have received would have been $150,-891.34 almost the exact amount estimated by Mr. Grace.

The Tax Court attached signifiance to the fact that petitioner did not introduce evidence to show the market price of the wine in December, 1942. The purpose of the stipulation with regard to the average selling price of the wine in 1942 was to establish the market value of the wine and the price at which it could have been sold in the regular course of business. In agreeing to the stipulation of the average price at which the wine was sold in 1942 respondent was necessarily fully informed of the price at which wine was sold in December, 1942. If that price had been appreciably higher than the average price for the year there can be no doubt that respondent would

have introduced such fact in evidence. Also it is obvious that Mr. Grace was familiar with the price in December, 1942 and his estimate of the price is consistent with the average price for the year. The stipulated average price and respondent's failure to suggest that the price was higher in December, 1942 together with his failure to challenge Mr. Grace's estimate of the price at which the wine could have been sold in the regular course of business should satisfactorily establish that the value of the wine in December of 1942 was not appreciably greater than the average price for the year.

Mr. Grace's allocation of $100,000 of the consideration to good will should be acceptable by the Court. There can be no doubt as to his qualification to place a value on the good will. He was experienced in the business and was the one who actually determined the price at which the assets would be sold. Furthermore, his valuation of the other principal assets, namely the wine at $150,000 and the plant at $125,000, are shown to be reasonable and accurate on the basis of actual sales. Mr. Grace's allocation is further corroborated by the testimony of Mr. Tapp who testified that the good will of the DeTurk Winery business was approximately $160,000 (R. 99.)

Petitioner respectfully submits that the record contains ample evidence from which a fair allocation of a portion of the consideration to the good will can be made and that the evidence clearly shows that at least $100,000 of the consideration should be allocated to the good will.

(f) The determination of the Tax Court that no part of the consideration received by petitioner was received for the good will of its winery business was clearly erroneous and should be reversed.

The stipulated facts and other evidence presented to the Tax Court clearly establish that the winery business of petitioner had a substantial good will or going concern value. The evidence also establishes that in the transaction with Garrett & Co. petitioner sold and transferred its entire wine business and retained only the reversionary interest in its plant and equipment. The Courts have recognized that the transfer of a going business necessarily involves the transfer of the good will of the business and have held that as a matter of law such a sale involves the sale of the good will even though it is not mentioned in the contract and even though the purchaser may have no apparent need or desire for the good will. The Courts have also recognized that the seller would not part with its good will without receiving consideration therefor and have held that part of the consideration must be allocated to the good will even though the contract of sale bases the price entirely upon the tangible assets transferred.

In the present case, in addition to the foregoing factors, the uncontradicted testimony of Mr. Grace, establishes that it was intended and understood that petitioner should receive approximately $100,000 for its good will and that petitioner would not have entered into the transaction on any other basis.

In rendering its decision herein the Tax Court completely disregarded all of the above evidence and

the applicable principles of law established by Court decisions and determined that no part of the consideration received by it was received for its good will or going concern value. Petitioner respectfully submits that the determination of the Tax Court is not supported by the evidence or the applicable principles of law and that said determination is clearly erroneous and should be reversed.

III. THE DE TURK WINERY BUSINESS WAS A DISTINCT BUSINESS UNIT OF PETITIONER AND GAIN DERIVED FROM THE SALE OF THAT UNITARY BUSINESS IS A CAPITAL GAIN.

The evidence establishes that the DeTurk Winery business consisting of the manufacture and sale of wines, was one of several different business operations in which the petitioner was engaged (R. 49, 50, 104.)

In the case of *Graham Mill and Elevator Co. v. Thomas,* 6 Cir., 1945, 152 F. (2d) 564, a corporation sold all of the assets making up four of its branch operations. The Court in sustaining the Commissioner and the District Court, held that a branch operation is a business entity and the sale resulted in a capital gain, though individual assets of the branch included inventory and other non-capital assets. *The Court observed that since the sale was not made in the course of business to customers but was a part of the ending of the business,* the transaction constituted a sale of capital assets.

The day after the above case was decided the U. S. Circuit Court of Appeals for the Second Circuit decided the case of *Williams v. McGowan,* 2 Cir. 152 F (2d) 570. In that case a surviving partner sold the business once conducted by the partnership. The District Court held that the sale was a sale of a business entity and any gain derived therefrom was capital gain. The Circuit Court, one Judge dissenting and agreeing with the District Court, held that the taxpayer had acquired the business and property of the partnership upon the death of his partner and had not sold the partnership interest as a distinct interest but had sold the individual assets, and gain or loss had to be computed as to each asset. The Court did recognize that *a partner's interest in a going firm* is for tax purposes to be regarded as a "capital asset" (*citing Stilgenbaur v. United States* 9 Cir., 115 F (2d) 283, 25 AFTR 966 and other cases.)

The distinction between the *Graham Mill* case, supra and the *William* case, supra, may be indicated by a remark made by the Tax Court in the case of *James H. Adamson* T. C. Memo Docket 3154, decided December 11, 1946 which case was cited with approval in the case of *United States v. Adamson,* 9 Cir., 1947, 161 F (2d) 942, as follows:

> " . . . we think it cannot be said that this petitioner . . . sold his partnership interest as such, *at least not in the sense that one sells an interest in a 'going concern'.*" (Italics ours.)

It would appear from the reasoning in the *Graham Mill* case, supra, from the dissenting opinion in the

Williams case, supra, and from the *Adamson* case, supra, that if a taxpayer disposes of a going concern as such, it disposes of a capital asset entity for tax purposes, without regard to the asset components thereof, and any gain resulting from the transaction is taxable as a capital gain. *It is emphasized that this was the very principle which the Commissioner advanced in the Graham Mill case when it meant more tax to have the transaction treated as a capital asset transaction. Since the District Court and the Circuit Court of Appeals sustained the Commissioner, he should be forced to adhere to his position and should not be permitted to blow hot and cold depending upon how the tax is affected.*

It is respectfully submitted that since the petitioner disposed of the DeTurk Winery business as a "going concern," which it had conducted for many years, the entire profit from the transaction with Garrett & Co. should be taxed as a long-term capital gain.

The Tax Court dismissed this contention on the ground that under its construction of the transaction there was not a sale of the business as a unit but a mere sale of wine and barrels and a lease of the winery. For the reason set forth in the preceding section of this brief petitioner submits that the transaction between petitioner and Garrett & Co. was intended to be and actually was a sale of petitioner's entire winery business and was not a mere sale of wine and barrels. Petitioner further submits that the Tax Court erred in determining that the trans-

action was not a sale of the entire business as a unit the gain from which constituted long term capital gain under the authorities cited.

IV. PETITIONER'S INVENTORY OF WINE WAS CONVERTED INTO A CAPITAL ASSET WHEN PETITIONER DETERMINED TO DISPOSE OF ITS WINERY BUSINESS AND THE ASSETS THEREOF AND THE GAIN REALIZED UPON THE SALE CONSTITUTED LONG TERM CAPITAL GAIN.

The record establishes that in 1942 just prior to the crushing season—October and November—the petitioner decided to sell its winery business. The record indicates that though it manufactured but 4,959 gallons of wine in 1942, compared with a usual annual production of approximately 200,000 gallons of wine, it continued to conduct its business and sold wines up to January 1, 1943 (R. 104.) The record indicates that in January, sometime prior to January 20, 1943, the petitioner did transfer everything connected with its winery business to Garrett & Co. The question arises, did the item of wine inventory which had been an inventory asset held for sale to customers in the ordinary course of business lose that characteristic and become a capital assets prior to the sale to Garrett & Co.

It appears that whether or not a sale or exchange involves a capital asset depends upon the nature of the asset *at the time of the sale or exchange.* The Commissioner's regulations, Regulation 111, Sec. 29.117-1 concede this specifically as to certain types

of capital assets and since the statutory definition of capital asset is the same as to all types of capital assets it would appear that the said regulation would apply to all types of capital assets.

In the case of *Lurie v. Commissioner,* 9 Cir., 1946, 156 (2d) 436, the petitioner held unregistered notes for over 24 months. Just before the notes were retired they were put in registered form. As unregistered notes they were not capital assets, as registered notes they were. The taxpayer reported the gain on the retirement as long term capital gain. The Commissioner and the Tax Court treated the gain as ordinary income because the notes had not been held *as registered notes* for the 18 months holding period to qualify as long term capital assets. The Circuit Court reversed the Tax Court holding that so long as the asset was a capital asset at the time of the sale or exchange, and as long as it had been held the necessary period, regardless of whether during that entire period it was a capital asset, the gain from the sale or exchange was a long term capital gain under the statute.

The same principle was applied in the case of *Commissioner v. Euleon Jock Grocery,* 5 Cir., 1947, 159 F (2d) 324.

It would follow from these decisions, that if the wine inventory lost its characteristic as an inventory or stock in trade asset at any time prior to the sale to Garrett & Co., the gain on the sale of the wine, excepting on 4,959 gallons manufactured in October,

1942, would be taxable as long term capital gain because all the wine excepting the 4,959 gallons, was held over 6 months. The question arises as to whether the wine did change its characteristic prior to the sale to Garrett & Co.

The authorities are consistent in the proposition that where a taxpayer is no longer carrying on a business the assets which previously qualified as business assets or stock in trade, lose their characteristic as such and become capital assets.

In the *Adamson* case, T. C. Memo, supra, the Tax Court held that property which constituted stock in trade of a partnership was no longer stock in trade after the partnership had gone out of business and the property was being held for "division and distribution."

In *Three States Lumber Co.* 7 Cir., 1946, 158 F (2d) 61, the Court in reversing the Tax Court held that in a case where the taxpayer had quit the lumber business and was selling its timber in "activities incidental to an orderly liquidation" the timber was no longer property held primarily for sale to customers in the ordinary course of business but was a capital asset.

In the two cases above cited there was a substantial lapse of time between the going out of business and the disposition of the assets, but isn't this just a matter of degree? If it is the going-out of business, if it is the change in business, or if it is the change from holding of the asset for sale to customers in

the ordinary course of business to a holding of it for sale in some other manner or for some other purpose, then that change takes effect *at the time* the reason for the change takes place, and whether the asset is sold 10 days or 10 years after the change becomes effective, the treatment of the sale for tax purposes would be the same.

In this case the petitioner's business of manufacturing and selling wine consisted of making wine, aging it for the customary time of 6 months to 2 years and then selling it to its trade customers. In conducting this business it always had a stock of salable wine available while other wine was in the necessary aging process. The petitioner was not in the business of selling its entire stock of wine at one time, together with all equipment and cooperage. *(Butler Consol. Coal Co.* 6 TC 183.) From January 1, 1943 the time this taxpayer's negotiations with Garrett & Co. reached the stage where the sale to Garrett & Co. seemed assured and the petitioner discontinued its regular business sales, the wine inventory was no longer held for sale to customers in the ordinary course of business, but became one of the component parts of a group of assets which were held for and later transferred in an isolated transaction, which was a type of transaction of an entirely different nature than the transactions theretofore had in the ordinary course of the business of manufacturing and selling wine. The sale to Garrett & Co. was not a sale to a customer in the ordinary course of business, and therefore when the wine became an asset held for

that purpose, whether for one day or 20 days it was no longer an asset held for sale to customers in the ordinary course of business.

It is respectfully submitted that the characteristic of petitioner's stock of wine was changed to a capital asset when held for sale to Garrett & Co. in an isolated transaction and therefore excepting as to 4,959 gallons which had not been held for 6 months and the profit on the sale of which can be computed from the record the profit on the sale of the wine to Garrett & Co. should be treated as a long-term capital gain.

Petitioner respectfully submits that the Tax Court erred in determining that the wine was not converted into a capital asset prior to the sale to Garrett & Co. and in determining that the gain from the sale of the wine was ordinary income.

V. CONCLUSION.

Petitioner respectfully submits:

(1.) That the evidence and authorities cited and discussed in this brief clearly establish that in the transaction between petitioner and Garrett & Co., petitioner sold its entire winery business including its good will and that at least $100,000 of the consideration received by petitioner was received by it for its good will.

(2.) That since the transaction was a sale of its entire winery business the entire gain consti-

tuted long term capital gain and not ordinary income.

(3.) That prior to the sale the wine inventory was converted into a capital asset and the gain realized from the sale of the wine (except 4,959 gallons) was long term capital gain and not ordinary income.

Petitioner further respectfully submits that the determination of the Tax Court that the transaction between petitioner and Garrett & Co. was merely a sale of wine and barrels and a lease of the winery and that the entire gain constituted ordinary income is clearly erroneous and should be reversed.

Dated, San Francisco, California,
October 15, 1948.

Respectfully submitted,
George H. Koster,
Bayley Kohlmeier,
Attorneys for Petitioner.